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REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Summary

The sharp increase in the value of the dollar from 1980 to 1985 has fueled rising discontent with the present exchange rate system. Many countries, including the United States, have expressed interest in reforming the international monetary system to provide greater stability to currency values. But there remains a wide divergence of views on both the wisdom and feasibility of altering the current system. Reform, therefore, is likely to be a gradual process.

There is increased support for fixed exchange rates or target zones for currencies. But since disruptive exchange rate changes are the manifestation rather than the source of most economic problems, the most important reform is better macroeconomic policies. The international harmonization of policies necessary to maintain stable exchange rates remains difficult, though, given the reluctance of governments to subordinate domestic policy to exchange rate considerations. The plan approved at the Tokyo summit for increased coordination and monitoring of policies is a promising first step.

Increasing Frustration With The Current System

The appreciation of the dollar, which rose nearly 56 percent between July 1980 and February 1985 on a trade-weighted basis relative to the currencies of the ten largest industrial countries, has had a powerful impact on

world economy. The strong dollar is the major cause of the $271 billion in U.S. current account deficits during the past three years and of its shift from the world's largest creditor country to the largest industrial debtor country. The European nations, which need investment capital to encourage growth and reduce double-digit unemployment rates, have been critical of high U.S. interest rates, which encouraged capital flows to this country.

The pressures on the world trading system resulting from the sharp currency changes of the past few years have increased support for international monetary reform. France has campaigned for an international monetary conference and the Group of 24, which represents developing countries, has urged the International Monetary Fund to study a system of "target zones," under which countries coordinate policies and market intervention activities to keep exchange rates within agreed ranges. The first-term Reagan administration view, which opposed intervention in exchange markets and accepted the strong dollar as a reflection of confidence in the U.S. economy, has also shifted considerably. In his 1986 State of the Union address, President Reagan said "We must never again permit wild currency swings to cripple our farmers and other exporters," and instructed Treasury Secretary James Baker to study the possibility of an international monetary conference.

The benign neglect of exchange rate policy ended September 22, 1985, when the Group of Five -- the United States, Japan, West Germany, France and Great Britain -- agreed to take measures to lower the value of the dollar. Since then the dollar has fallen 16.3 percent against the ten-nation basket of currencies (see Table 1) and the G-5 has orchestrated two coordinated interest rate cuts. At the recent economic summit in Tokyo, participants agreed to try to formalize and expand the G-5 system to promote economic growth and exchange rate stability. The agreement, termed "managed floating," requires the finance ministers of the seven summit countries to meet periodically to coordinate policy and monitor economic data, taking into account the following indicators: economic growth rates, inflation rates, interest rates, unemployment rates, budget deficits, current account and trade balances, monetary growth rates, reserves and exchange rates. The group is instructed to develop remedial measures whenever there is significant deviation from the projected course. There is no indication, however, that the agreement is intended to control the day-to-day variations in exchange rates or to set target zones for currencies. The plan is similar to that suggested by the IMF's interim committee in April for multilateral surveillance by the IMF based on "objective indicators."

The Floating Exchange Rate System

Economic events in the 1960s and early 1970s weakened the system of fixed exchange rates established at the Bretton Woods Conference in 1944. The Smithsonian agreement in 1971, which devalued the dollar, failed to stem mounting pressure on the system. Major currencies began to float when a second currency alignment collapsed in March 1973, and attempts to reestablish fixed rates were abandoned in the turbulence following the first oil shock. Three years later, in January 1976, the finance ministers of the IMF nations officially approved the system of floating currencies while allowing countries to maintain the exchange arrangement of their choice.

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Table 1: Changes in the Dollar

Currency	Percent Change From September 20, 1985 to May 2, 1986	Percent Change From February 26, 1985 to May 2, 1986	Percent of Dollar's Appreciation Reversed*
Japanese yen	-30.0%	-35.2%	223.2%
Canadian dollar	-0.1	-1.8	8.4
Swiss franc	-22.0	-37.0	81.1
German mark	-23.6	-36.5	73.0
British pound	-11.1	-31.5	35.8
French franc	-20.1	-33.8	54.5
Italian lira	-22.0	-30.2	48.8
Special Drawing Rights	-12.7	-19.1	57.8
European Currency Unit	-20.4	-34.2	41.0
Trade-Weighted Average of G-10 Currencies	-16.3	-24.7	50.6

*This column indicates the portion of dollar appreciation between July 22, 1980 and February 26, 1985 that has been reversed by the subsequent depreciation of the dollar.

Source: Department of the Treasury (based on London mid-day rates)

While most major currencies have been allowed to float, a number of developing nations and small industrial countries have remained with fixed exchange rates. In 1985, 68 percent of the IMF's 149 member-countries maintained a fixed exchange rate (see Table 2). Thirty-six countries peg their currency to the U.S. dollar, 14 to the French franc and 13 to the IMF's Special Drawing Rights. The remainder are linked to another currency or basket of currencies. The popularity of flexible exchange rates, as indicated by the number of countries that follow this system, has risen from 22.9 percent to 32 percent during the past eight years.

Floating exchange rates were expected to eliminate currency misalignments and automatically balance a country's external payments. Trade deficits, in this view, would be corrected by a declining currency that increased exports and reduced imports, making it unnecessary to impose restrictions on trade and capital flows for macroeconomic reasons and enhancing the efficiency of resource allocation in the world economy.

The most important argument in favor of flexible exchange rates is that, on paper at least, it would insulate a nation's economy against shocks from abroad and allow policymakers greater independence to pursue domestic stabilization goals. Excess supply or demand for a currency under a fixed exchange rate system forces monetary authorities to adjust the currency supply to keep the exchange rate at a specific level. As a result, governments lose control

of monetary policy. Under floating rates, however, the price (exchange rate) is allowed to equilibrate demand and supply, permitting monetary authorities to pursue domestic objectives, such as interest rate levels and money supply growth.

Table 2: Types of Exchange Arrangements Maintained by IMF Members

(percent of total)

End of Year*	Fixed**	Managed Floating	Freely Floating
1977	77.1%	12.2%	10.7%
1978	74.5	15.3	10.2
1979	72.7	16.5	10.8
1980	72.1	17.2	10.7
1981	72.5	16.9	10.6
1982	71.7	17.3	11.0
1983	69.0	20.0	11.0
1984	68.7	17.7	13.6
1985	68.0	17.0	15.0

*Figures for 1977 and 1985 are for October and March, respectively.

**Includes pegged arrangements and arrangements in which flexibility is limited vis-a-vis a single currency. Freely floating includes cooperative arrangements and independently floating arrangements.

Source: IMF Survey, September 23, 1985.

But the appreciation of the dollar from 1980 to 1985 -- the largest real exchange rate movement in modern history -- and the unprecedented U.S. trade deficits indicate that the floating exchange rate system is not working as expected. While flexible rates have freed governments from worrying about the impact of domestic economic policies on the exchange rate, they have not freed economies from the impact of exchange rate changes. Nor have they insulated countries from overseas shocks as hoped.

Under the floating exchange rate system, there has been an increase in the volatility of exchange rates and a significant misalignment of currencies. According to the IMF, the average monthly fluctuation in the exchange rates of industrial countries was nearly ten times greater from 1971 to 1981 than from 1948 to 1971. The increase in the volatility of four major currencies under the floating exchange rate system is shown in Table 3. There has also been a marked increase in swings in real exchange rates under the floating system (see Table 4).

Table 3: Exchange Rate Volatility*

Currency	1968	1969	1975	1982
German mark	0.3%	1.2%	1.7%	1.6%
French franc	0.1	2.3	1.6	2.2
Japanese yen	n.a.	n.a.	0.7	2.5
British pound	0.7	0.2	1.0	1.1

*Coefficient of variation of daily nominal exchange rate against dollar around six-month moving average, expressed as percentage.

Source: John Williamson, The Exchange Rate System (Washington, D.C.: Institute for International Economics, 1983), p. 12.

Table 4: Maximum Swings in Real Exchange Rates

(in percent)

Currency	1963-72	1973-82
German mark	13%	22%
French franc	27	19
Japanese yen	14	35
British pound	17	60
U.S. dollar	14	32
Average	17	34

Source: John Williamson, The Exchange Rate System (Washington, D.C.: Institute for International Economics, 1983), p. 17.

Although in some sense it is incorrect to say that a currency whose value is determined by market forces is "overvalued," economists generally believe the dollar's strength in the first half of the 1980s was not justified by economic fundamentals, such as the U.S. current account and changes in productivity and prices. John Williamson of the Institute for International Economics calculated that in September 1985 the dollar was overvalued by 30 to 40 percent compared with the underlying competitive relationship between the United States and other major countries.

The volatility of exchange rates is explained by the fact that, like other financial assets, the price reflects all the information that may have a bearing on its value. The market continually appraises new information and adjusts its expectations of the future. The increased volatility of exchange rates during the past ten years reflects the tremendous surge in capital-flows resulting from the growing integration of world capital markets. Advocates of flexible rates, who expected currency values to be determined largely by trade

flows, did not anticipate the doubling of the volume of foreign exchange trading from $75 billion a day in 1979 to $150 billion in 1984 (see Table 5). Former Citicorp chairman Walter Wriston estimates that international dollar capital flows now exceed world trade volume by a factor of fifty to one.

Table 5: Daily Foreign-Exchange Trading*

(percentage of total)

Market	1979	1984
London	33%	33%
New York	23	24
Frankfurt	15	11
Zurich	13	14
Paris	5	3
Singapore	4	5
Hong Kong	4	5
Tokyo	3	5

*Daily volume totaled $75 billion in 1979 and $150 billion in 1984.

Source: The Economist, November 30, 1985, p. 83.

It is widely believed that misaligned currencies are the result of inappropriate macroeconomic policies that push exchange rates away from levels consistent with current account balances, allowing for small net capital flows. Inefficiencies in the exchange market may also explain the divergence of exchange rates from equilibrium levels. An appreciating currency creates a bandwagon effect, as traders rush to buy it, hoping to make a profit by selling it at a higher value. Economists believe that exchange rates can be pushed away from equilibrium values as long as participants believe that the risk of reversal falls short of the prospect of further gain. This bandwagon effect, based on market dynamics, can outweigh economic fundamentals and create a speculative bubble that persists for long periods.

Although studies of the effects of exchange rate volatility on trade have reached no firm conclusion, a recent report by Keith Maskus of the Federal Reserve Bank of Kansas City estimates that volatility reduced total U.S. trade by 3.2 percent between 1974 and 1984. It had the greatest impact on agricultural trade, lowering it by 6 percent. Rapid exchange rate changes hinder trade by creating uncertainty about the profits or costs of international transactions. Volatility can also lead to higher prices by causing traders to add a risk premium to cover unanticipated exchange rate fluctuations.

The misalignment of currencies is a more serious problem that leads to a shifting of resources between industries producing tradable goods and those producing nontradables on the basis of misleading prices. While such dislocation costs may be worthwhile to achieve a permanent improvement in the allocation of resources, the cost-benefit ratio is not as favorable when based on a

temporary misalignment of currencies. These costs include the retraining of labor and the construction of new capital equipment, both of which absorb real resources.

The manufacturing sector, in particular, benefits from an environment of stability, in which factors such as cost and profit margins can be calculated with a degree of certainty. An overvalued exchange rate leads industries to shift production overseas or scrap capacity that could be productively employed at equilibrium exchange rates. Similarly, an undervalued exchange rate can encourage investment in excess capacity that will later have to be abandoned or subsidized. Moreover, repeated wide swings in currency values give rise to uncertainties that discourage investment. Not surprisingly, the Business Roundtable, composed of the leaders of the 200 largest U.S. firms, has called for an international monetary conference to increase the stability of exchange rates.

An overvalued currency increases unemployment, as the retraining of workers released from declining industries typically begins only after months or years of unemployment. Not surprisingly, the hike in unemployment often encourages a surge of protectionist pressure. C. Fred Bergsten, director of the Institute for International Economics, points out that three major postwar episodes in U.S.-Japan trade friction originated in periods of an overvalued dollar. Some economists believe that repeated misalignments raise the rate of inflation. It has been observed that pressure for wage increases following a currency depreciation, which raises prices, is greater than the pressure for wage restraint following currency appreciation. A depreciation followed by a matching appreciation, therefore, will leave the price level higher than it would have been.

A Return To Fixed Exchange Rates?

These problems have prompted some politicians and economists to favor a return to fixed rates to provide a more stable environment for economic growth. There has even been some support, notably from Rep. Jack Kemp (R, N.Y.), for a new gold standard. The two major elements of the gold standard were: (1) maintenance of the equal value of the currency and gold through the unrestricted purchase and sale of gold at a fixed price; and (2) limiting the money supply through gold reserve requirements. Exchange rates were kept within a narrow range through gold flows between countries. Since the money supply was determined by the gold reserve, an inflow or outflow of gold caused an automatic expansion of money and credit.

Those favoring a return to the gold standard contend that it is a long-term anchor to the price level that will restore greater stability to prices as well as exchange rates. But much of the support is based on an idealized view of the gold-standard era as an age of unmatched economic progress and monetary stability. In fact, while the United States was on a gold standard for most of the time from 1834 to 1933, there were alternating periods of deflation and inflation. And in Japan, the deflationary policies pursued in the second half of the 1920s to return to the gold standard reduced real farm income by about one-third and contributed to the country's political problems.

Most economists agree that gold is too speculative a commodity on which to base monetary policy. The price of gold is sensitive to many factors, such as political disorder, that make it difficult to maintain the equivalence of

gold and currency at a fixed price. An effective gold standard requires an adequate and steady growth in the monetary stock of gold to promote economic growth. The major suppliers of gold, however, are the Soviet Union and South Africa, neither of which for political reasons can be considered reliable sources.

There is more support for reforms along the lines of the Bretton Woods system, which emerged in response to the breakdown of the gold standard and the chaos of the 1930s. The 1944 Bretton Woods Conference of 44 nations established exchange rates pegged to the U.S. dollar, which was in turn pegged to gold at the price of $35 an ounce. Countries were expected to follow economic policies that maintained their currency's value at the specified level and intervene when it got out of line. But in practice, there were frequent devaluations, since countries were allowed to alter exchange rates when it became clear that balance of payments deficits were not temporary in nature.

Bretton Woods was basically an agreement that the United States would maintain domestic stability and other countries would peg their currencies to the dollar and accumulate their reserves in gold-convertible dollars. As noted above, this meant that governments surrendered effective control of monetary policy. In 1969, for example, Germany experienced a 25 percent increase in its money supply in a single week.

The United States was willing to endure several recessions in the 1940s and 1950s to assure the stability of the dollar. But in the 1960s, the decision to pursue both the war in Vietnam and the war on poverty overrode economic considerations. Finally, worldwide inflation overwhelmed the political will to maintain fixed rates. But it is probable that the Bretton Woods system would have broken down sooner or later even without the burst of inflation. With the overvalued dollar leading to the accumulation of dollar reserves abroad relative to the U.S. gold stock, the dollar convertibility of gold became increasingly doubtful. The decline in the U.S. gold stock from $23.4 billion in 1949 to $10.1 billion in 1971 led to the decision to end the covertibility of dollars.

Support for a new Bretton Woods system reflects in part a nostalgia for the impressive growth and stability of that period, without recognizing that the problems that caused the downfall of fixed exchange rates still exist. In the 1960s, major industrial countries did experience faster growth and less inflation than under the floating exchange rate system (see Table 6). But the two periods differ in many respects other than the exchange rate regime. Rapid growth in Europe and Japan in the 1960s was part of the process of catching up after World War II, while two major oil market shocks came in the 1970s. Moreover, exchange rates in the latter period have not been allowed to float cleanly, as prescribed by advocates of floating, as governments have used various methods to manage exchange rates.

The pressures created by large U.S. budget deficits during the past five years would have broken down any fixed exchange rate system. The rise of the dollar has acted as an equilibrating mechanism enabling the current account balance to adjust to satisfy the U.S. appetite for capital. Under a fixed exchange rate system, the likely remedy for the high dollar -- easy money -- would have brought a return of high inflation rates. Floating exchange rates have probably absorbed the shocks of the last 15 years better than any fixed rate regime.

Table 6: Economic Performance of OECD Countries

(in percent)

	1960-69	1970-72	1973-82
Average real GNP growth rate	4.95%	4.12%	2.45%
Average inflation rate	2.84	5.20	9.88
Average unemployment rate	2.73	3.40	5.34

Source: Jeffrey R. Shafer and Bonnie E. Loopesko, "Floating Exchange Rates after Ten Years," Brookings Papers on Economic Activity, 1:1983, p. 6.

Proposals For Target Zones

Given the frustration with floating rates and the difficulty of returning to fixed rates, some analysts have proposed a compromise: target zones. There is support for this proposal, both as a first step toward fixed rates and as an arrangement superior to fixed rates -- which some economists view as incompatible with the free movement of capital.

In contrast to the September 1985 G-5 agreement, which decided that certain exchange rates were wrong, target zone schemes specify which rates are correct. Some advocates of this approach claim that only managed rates can prevent the misalignment of real exchange rates that occurs under both fixed and floating regimes. The Institute for International Economics' John Williamson suggests that financial authorities establish wide currency ranges, such as plus or minus 10 percent, that are not clearly wrong. These ranges, he believes, should be continuously readjusted to account for differing rates of inflation. In contrast to this approach, which in effect sets zones for real exchange rates, Ronald McKinnon of Stanford University favors target zones for nominal exchange rates. This proposal, which is sometimes referred to as "global monetarism," is a more ambitious plan that would not allow divergent rates of inflation. The inherent weakness of both plans, though, is that they would rely on the willingness of governments to change domestic economic policies when a currency threatens to break out of the accepted range.

Advocates of target zones cite the European Monetary System, which links the currencies of eight countries, as a model for a global system. The EMS requires each government, with the exception of Italy, to keep its currency within 2.25 percent of the target level. The system has been surprisingly stable since its creation in 1979. Despite the sharp appreciation of the dollar, the devaluation of the French franc last month was the first realignment in currencies in three years. The EMS has been successful because its members have been willing to link their currencies and policies to West Germany's, resulting in a convergence of inflation rates. Five years ago, inflation in EMS member countries ranged from 5 percent to 22 percent; that spread has now narrowed to 0.1 percent to 7.6 percent.

Support for this type of system includes congressional Democrats, who in this year's annual report of the Joint Economic Committee called on the administration to establish a target zone system. But last April, the IMF's interim

committee rejected a proposal for target zones. West Germany, in particular, is an outspoken opponent of proposals to link the dollar, yen and EMS currencies because it fears that such an arrangement might force Bonn to accept a higher rate of inflation. Many Europeans believe that the United States does not pay sufficient attention to the interests of foreign countries in setting its economic policy. If it cannot even produce a budget to serve its own interests, they argue, it is unlikely to fulfill fiscal promises to foreigners.

A major complication of these schemes is the establishment of appropriate target zones. The disagreement at the Tokyo summit over whether the dollar had fallen sufficiently illustrates the difficulty of reaching agreement on currency values. In February, in fact, the two chief financial officers of the U.S. government, Federal Reserve Board chairman Paul Volcker and Treasury Secretary James Baker, disagreed over the appropriate level for the dollar. Economists as well as politicians have diverse opinions on the right exchange rate. Mr. McKinnon, for example, believes that a rate of Y200=$1.00 would achieve purchasing power parity, while Brookings Institution economist Edward Bernstein argues that a rate of Y120=$1.00 is appropriate.

Setting exchange rates that will equilibrate trade balances is difficult in practice, since economists are unsure of the timing and impact of exchange rates on trade. The issue is further complicated by the uncertainty over how policy changes influence currency values. For example, the U.S. budget deficit has long been blamed for the overvalued dollar, but a reduction in that deficit might increase confidence in the U.S. economy and strengthen the dollar by encouraging capital flows into the country.

Conclusion

The Treasury Department, which is continuing to study the possibility of an international monetary conference, plans to reach a decision by the end of the year. Legislators as diverse as Rep. Kemp and Sen. Bill Bradley (D, N.J.) support reform; most of the comprehensive trade bills under consideration call for a monetary conference. In addition to France, Prime Minister Yasuhiro Nakasone, who favors "managed flexibility" rather than target zones, has indicated his support for a monetary conference.

If the plan agreed to at the summit is successful, it will reduce the support for a global conference. But many economists doubt that the plan will have much impact. With no enforcement mechanism other than peer pressure and public opinion, it is an open question whether or not the agreement will improve policymaking and enhance currency stability. Over the last five years, for example, the United States has largely ignored international pressure to reduce its budget deficit.

While there is a consensus in favor of more stable exchange rates, there is less agreement on how to achieve it. The debate centers on whether it is better to first set exchange rates and then coordinate economic policy in order to maintain those rates or to first synchronize policies to achieve stable rates. Advocates of setting rates first argue that it would provide a catalyst for the timely adoption of sound economic policies. Instead of allowing currency misalignment to force corrective action, they argue, setting target zones would discourage policies that lead to an over- or under-valued currency by forcing governments to take into account international as well as domestic

considerations. If a government had to explain what impact its fiscal policy had on exchange rates, for example, it might lead to better policy decisions.

But since macroeconomic policies, particularly fiscal policy, have been the major cause of misaligned currencies during the past few years, policy reform appears a more sensible solution than an overhaul of the international monetary system. If government policies converge, exchange rates will be sufficiently stable, whether they are fixed, floating, or somewhere in between. But if policies are not in harmony, rates will be unstable regardless of the rules. Disruptive exchange rate changes are usually the consequence rather than the cause of economic problems. To blame floating exchange rates for the world's economic problems is like blaming the messenger for bringing bad news. If currencies were somehow fixed, the results of poor policy would be likely to show up elsewhere where they could be harder to deal with.

The harmonization of policies necessary to maintain stable exchange rates requires that governments surrender a degree of policy autonomy. Even though the needed policy changes may be in their best interests, most countries are reluctant to yield economic sovereignty. When the rules become too hard to live with, nations tend to change the rules rather than the policy.

The G-5 agreement reflected a convergence in the interests of the major nations: the high dollar was fueling protectionism in Congress while European and Japanese investment capital continued to flow into the United States. But already the consensus on exchange rates has broken down and some countries remain reluctant to coordinate policies. At the summit, for example, West Germany agreed to the plan proposed by the United States on the condition that it would not be implemented mechanically or automatically, stimulating Germany's economy against its wishes.

The lack of consensus among nations makes it clear that an overhaul of the current system is unlikely in the near future. Moreover, the tenuousness of government control over the central bank in many countries further complicates the task of coordination. At the same time, though, conditions are ripe for constructive changes, given the frustration with floating rates and the relative convergence of economic conditions in major industrial countries. Change is likely to come gradually as governments realize that stable, consistent policies leading to stable exchange rates are preferable. Having seen the costs of acting independently, perhaps political leaders will be better able to coordinate their policies and encourage stability in the international monetary system.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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